Credit Card Activities

Consider the following procedures at each examination. Examiners are encouraged to exclude items deemed unnecessary. This procedural analysis does not represent every possible action to be taken during an examination. The references are not intended to be all-inclusive and additional guidance may exist. Many of these procedures will address more than one of the Standards and Associated Risks. For the examination process to be successful, examiners must maintain open communication with bank management and discuss relevant concerns as they arise.

IMPORTANT

This reference applies to both credit card banks and those banks where credit card receivables are not the primary loan products. Credit card banks deal with large volumes of accounts, have highly automated systems, and rely on credit scoring models. Consequently, credit card banks require more specialized policies and procedures. FDIC Examiners should use the Credit Card Bank Examination Guidance Handbook as their primary reference tool when assessing a credit card bank. The following document, which addresses many of the same issues found in credit card banks, is designed to assess the asset quality aspects of credit card operations. The FDIC Handbook includes further guidance regarding capital, earnings, interest rate risk, and liquidity.

The analysis of operating policies and procedures is key to the examination of credit card banks and credit card operations. Credit card lending is characterized by a high volume of accounts, homogenous loan pools, and small-dollar balances; therefore, the review of individual accounts is not practical. Instead, examination procedures should focus on evaluating policies, procedures, and internal controls in conjunction with performing other selected functions. The goal is not confined to identifying current portfolio problems. The process should include an investigation of potential problems that may result from ineffective policies, unfavorable trends, lending concentrations, or nonadherence to policies.

GENERAL

1 Review UBPR data to determine the volume of credit card activity. UBPR ratios provide an overview of the financial condition of an institution, and will assist examiners with determining the nature of the credit card operations. (Note: Peer group comparisons of credit card banks or those banks with large credit card operations with commercial financial institutions are not relevant due to the unique aspects of credit card bank operations.)

2 Review applicable state and Federal laws and the bank's charter. Some credit card banks operate under restrictive laws or charters that may affect, either directly or indirectly, the lending and deposit functions and earnings potential.

3 Determine if management plans to offer new products, enter new market niches, or grow the credit card portfolio significantly. New offerings may include affinity cards, co-branded cards, secured cards, or purchasing cards.

4 Determine whether the institution is engaged in subprime credit card lending or plans to in the future. If subprime lending exists or is planned, complete the subprime lending examination procedures contained in the Loan References in conjunction with these credit card guidelines.

5 Review correspondence the institution has received from credit card networks (i.e.,Visa, Mastercard). These agencies perform periodic reviews of their members.

POLICY CONSIDERATIONS

6 Review the credit card policy. Policy guidelines should address the following items:

6 A 1. Adequate screening of account applicants.
2. Standards for approving accounts and determining credit line size.
3. Minimum standards for documentation.
4. Internal controls to prevent and detect fraud.
a. Frequent review of delinquent accounts and other review procedures.
b. Delinquency notification and collection procedures.
c. Criteria for freezing accounts and charging off balances.
d. Criteria for curing and reaging delinquent accounts.
e. Reissuance of expired cards to obligors with unsatisfactory credit histories.
f. Approval of overlimits and overrides.
g. Cardholder information security.
5. Due diligence process prior to engaging the services of a third party as well as ongoing management.

AUDIT

7 Review the adequacy of the audit function regarding credit card operations.

7A Determine if the audit program identifies contraventions of internal policy, credit card network (i.e.,VISA, MasterCard) regulations, and written contracts.

7B Determine if audit procedures include reviewing the accuracy and integrity of the institution's system for reporting past due status of credit card loans as well as other management information systems.

7C Determine if audit procedures include reviewing computer-driven models.

7D Determine if independent tests of automated procedures are performed. For example, a sample of automatically re-aged accounts may be independently reviewed to test the integrity of automated systems.

7E Determine whether audit procedures include a review of credit card processing operations. (Note: The Product Control File, which governs credit card processing, frequently gives rise to a number of internal control weaknesses. A lack of segregation of duties and access controls are common weaknesses. Management should be aware of the risks and have an audit staff with the expertise to evaluate procedures and suggest controls for the risk.)

7F Determine if audit procedures include a review of services provided by outside vendors. (Note: Such services may include telemarketing, data processing, and direct mail. Both the performance of vendor and documentation of the relationship should be reviewed.)

8 Determine if management has reviewed and appropriately responded to audit findings regarding credit card operations.

FRAUD

9 Evaluate management's strategy for controlling fraud. (Frequently, strategies emphasize application review to prevent fraudulent accounts from being booked or using neural networks to identify fraudulent transactions.) Common controls include the following items:

9 A Methods of preventing application fraud such as name and address verification, duplicate application detection, social security number verification, etc.

9 B Physical aspects of cards such as holograms and enriched information on the magnetic stripe.

9 C Adequate staffing and training of fraud detection department.

9 D Computer systems to identify suspicious activity.

9 E Procedures for issuing cards to prevent interception and activation.

9 F Procedures for handling returned cards, statements, PINs, checks, and lost or stolen cards.

9 G Investigation and documentation of cases of suspected fraud.

9 H Freezing accounts with suspicious activity.

9 I Procedures for filing Suspicious Activity Reports (SAR).

9 J Procedures for access to and alteration of customer information.

9 K Controls over card holder payments, account balance records, and chargeback administration.

9 L Account authorization procedures

10 Determine whether management receives adequate fraud monitoring reports. The following are two common types of reports:

10 A Out-of-Pattern or Sequence of Purchase Reports. Both identify suspicious transactions which do not fit an individual cardholder's established purchasing pattern.

10 B Suspicious Purchasing Pattern Reports. Identify certain types of purchases, such as electronics or jewelry, which can correlate with fraudulent activity.

11 Consider the credit card fraud warning signs outlined in the Bank Fraud Section of the FDIC's Manual of Examination. Review consumer complaint correspondence from cardholders on file with the institution or primary federal regulator for irregularities and/or patterns of activity.

ACCOUNT SOLICITATION

12 Determine management's general approach to account solicitations. A variety of approaches and combination of approaches exist. Solicitations may be for preapproved or non-preapproved accounts and are usually done by mass mailings, telemarketing, or counter displays.

13 Determine the extent to which outside contractors are used in marketing programs. Mass mailing and telemarketing operations are frequently outsourced.

14 Review management's product and marketing program including the goals of the program, the basis of the approach, and product pricing. To attract the target market and obtain projected results, management must have a marketing program and product that appeal to the targeted market.

15 Determine how management identifies markets for new solicitations and evaluates expected performance.

15 A Identify the analytical procedures management uses to project the results of a particular solicitation. These procedures include response rates, usage rates, credit score distributions, and future delinquency and loss rates.

15 B Determine how management verifies projections before proceeding with a full-scale solicitation program (test marketing).

16 Determine if management monitors solicitation results and incorporates findings into future solicitations. This monitoring should be done for each major account segment.

17 Determine if management monitors and responds to adverse selection trends. Adverse selection occurs when a disproportionate number of poor credit risks respond to an offer. The result is a larger percentage of riskier accounts comprising the solicitation response pool than projected.

18 Review affinity and co-branding relationships, and determine if the institution has control over the approval and acceptance of accounts. (Co-branding: A third party relationship that exists between a broad base of cardholders and a jointly sponsored credit card. The bank and usually a retail merchant are the sponsors. These cards have some form of value added features such as cash rebates or discounts on merchandise.)

19 Review new product offerings. With new product offerings, the market identification, testing, and ongoing monitoring take on heightened importance. Key concerns with new product offerings include the following issues:

19 A The amount of historical and test sample data available to analyze the product or solicitation.

19 B The speed at which the new product is introduced.

19 C The size of solicitations.

20 Discuss any problems management had with the wording of solicitations or applications. Imprecise offer terms can lead to asset quality and earnings problems. Noted problems often included the following errors:

20 A No expiration date on the offer.

20 B No wording that gives management discretion in setting credit lines.

20 C Insufficient information requirements on applications.

21 Review balance transfer policies and monitoring practices. Balance transfers generally result in higher exposure and tend to distort ratios due to the immediate booking of relatively large balances.

22 Review teaser interest rate practices. Without adequate controls, teaser rates may disguise a borrower's repayment capacity. In addition, higher attrition may occur when teaser rates expire.

PREDICTIVE MODELS

Generally, credit card banks use two distinct predictive models to limit risk and maximize profitability. The first model (referred to as a credit scoring model) is used in the initial application process. The second model (referred to as a behavioral model) is used in the management of existing accounts. Both models use a credit scorecard. The credit scorecard is a

table of characteristics, attributes, and scores that enables a credit grantor to calculate the risk of an account going bad.

General

23 Review management's integrated credit risk assessment and behavioral scoring models that are used in identifying and selecting prospective customers. Information derived from these models assists with quantifying and minimizing credit risk and fraud losses.

Credit Scoring

24 Determine the nature and extent that credit scores are used in the underwriting process.

25 Determine the degree of reliance placed on credit bureau score good and bad odds charts. These charts are only a starting point. With historical account data, management should develop its own good and bad odds chart. Given sufficient quantity and quality of historical information, a customized odds chart is more predictive than a credit bureau odds chart. This process is referred to as calibrating.

26 Determine whether a single or dual score model is used. A single score model will use credit bureau scores while a dual score matrix will calculate a score based on the combination of a custom score, usually based on credit application data, and credit bureau score. The more complex the operations, management should be using the more sophisticated dual scoring model.

Behavioral Scoring System

27 Determine whether management has implemented a behavior scoring system to manage existing accounts. The score is derived from a cardholder's payment and usage behavior with the card-issuing bank. A cardholder's historical performance with a particular institution is typically the best indicator of future performance with that institution. Behavior scores are frequently supplemented with credit bureau scores to enhance their predictive value.

28 Ascertain if management continually refines existing or considers new predictive models.

28 A Determine whether a champions and challengers system is in place. Such a system involves continual portfolio analysis and identification of predictive characteristics. Based on this analysis, existing models are revised and enhanced. The revised challenger model is then compared with the existing champion model. If the challenger is more predictive, it is adopted. This procedure is an ongoing system of refinement.

28 B Determine if management has adopted or is considering new predictive models. New models include revenue, revolving, bankruptcy, and payment predictors.

Validation

29 If using credit scoring, determine if management is validating scores. Validation compares account quality rank of accepted applications to that predicted by the system. As long as the rank orderings remain substantially the same, the scoring system remains valid.

29 A Review the statistical techniques used to validate each model used. Common statistical techniques used include K/S Test, Chi Square, Goodness of Fit Test, Divergence Statistics, and the Population Stability Test. (Examiners generally do not need to know the details of these tests, just that they are acceptable validation tests or techniques.)

29 B Determine if high and low override controls are in place and detailed on exception reports. Overrides can skew a statistical population and distort analysis.

PORTFOLIO ANALYSIS

General

30 Review customized credit card bank reports in FINDRS, if applicable. (FDIC Note: These reports provide various ratios and peer group data. However, even within the industry, peer group data may be distorted due to niche marketing, specialized card products, or extensive affiliate support.)

31 Determine if management is segmenting portfolios and considering the particular characteristics of each for delinquency, profitability, future marketing programs, ALLL calculations, and other purposes. (Note: Portfolios are commonly segmented based on geographic or demographic distribution, affinity relationship (cardholders belonging to a particular union, corporation, professional association, etc.), product type (premium or standard cards), credit bureau scores, or other segmentation basis.)

32 Determine whether geographic, customer base, card type, or other concentrations exist, and identify the unique risks posed by any of the portfolio segments or concentrations. Evaluate the degree of risk and consider mitigating factors.

33 Review how management uses portfolio information to identify developing trends, make strategic decisions, and detect potential problems.

33 A Determine how management reports identify the number and volume of workout and re-aged credits (delinquency status is changed by the institution without full collection of delinquent payments).

33 B Evaluate the portfolio information management reviews, such as asset quality ratios and vintage analysis (analysis of account performance of homogenous loans booked at a similar time using the same credit and pricing criteria).

34 Determine if cash advances are monitored and authorization procedures are in place. Cardholders with excessive debt may obtain cash advances to pay other debts.

35 Review the level and trend of the following portfolio ratios (FDIC: Refer to the Credit Card Bank Examination Guidance Handbook for an explanation of the following ratios):

35 A Average Balance of Delinquent Accounts (by 30-day time frames) to Average Balance of Non-Delinquent Accounts.

35 B Lagged Delinquency Rate and Nine-Month Net Charge-offs to Lag Rates.

35 C Net Charge-off Rate and Lagged Net Charge-off Rate.

35 D Re-aged Accounts and Partial Payment Plans to Total Active Accounts and to Average Total Loans.

35 E Total Past Due Loans to Gross Loans.

35 F Noncurrent Loans to Gross Loans.

36 Consider indicators of possible deterioration in asset quality such as the following items:

36 A Rapid growth may indicate a decrease in underwriting standards.

36 B Lowering minimum payment requirements and extending principal payment cycles (may result in negative amortization) may reflect less creditworthy accounts.

36 C The ratio of Total Accounts Being Charged-off to the Number of Accounts and Average Balance of Accounts, if high, may indicate a lax policy toward the number and level of credit lines granted to cardholders.

36 D Lower payment rates combined with higher average balances could indicate that borrowers are having trouble servicing their debt.

36 E The ratio of Income Earned Not Collected on Loans to Total Loans should be relatively low when compared to Total Past Due Loans to Gross Loans. If inordinately high, may indicate frequent reagings, inadequate collection procedures, or failure to charge-off credit card receivables timely.

36 F The average age of accounts may indicate that loss rates will rise for unseasoned accounts. Typically, loss rates are low for new offerings and increase to peak at 18-24 months after issue.

37 Evaluate management's practices on cure programs, such as re-aging, loan extensions, deferrals, fixed payment, and forgiveness.

37 A Determine that the use of cure programs are in compliance with the FFIEC Uniform Retail Credit Classification and Account Management Policy.

37 B Determine whether management monitors and analyzes the performance of each program (e.g., does the program achieve the objective of improving the borrower's subsequent performance, effect on delinquency ratios, etc.)

37 C Assess the current and potential impact of such programs on reported performance and profitability, including ALLL implications

37 D Determine if third parties purchase or fund loan payments to cure loan delinquencies and if so, assess impact.

38 Determine whether management developed contingent strategies to deal with rising delinquency levels, generally the first sign of account deterioration. Strategies could include the following issues:

38 A Reviewing accounts more frequently.

38 B Decreasing the size of credit lines.

38 C Freezing or closing accounts.

38 D Increasing collection efforts.

39 Ascertain compliance with credit card policies and procedures. Review a sample of credit card loans originated since the prior examination to determine compliance with policies and procedures.

40 Determine the level of classifications:

40 A Ascertain the accuracy and integrity of the institution's system for reporting past due status. Review a sample of loans to determine accuracy of past due status.

40 B Verify that the institution's classification and charge-off procedures adheres to, at a minimum, the guidance of the FFIEC Uniform Retail Credit Classification Policy.

Allowance for Loan and Lease Losses (ALLL)

41 Determine if ALLL policy and analytical procedures are in place. Roll rate analysis (migration of an account from one billing cycle to the next), generally performed for each portfolio segment, is the industry standard. However, some banks use the following additional or alternative methods:

41 A Delinquency analysis using a set percentage of loans over 60 days delinquent.

41 B Exposure analysis that projects net charge-off rates to each 30 day period of delinquency.

41 C Charge-off projections based on vintage analysis.

41 D Historical rolling average based on charge-off rates for the last six months.

41 E Analysis based on external economic forecasting services.

42 Review ALLL calculation techniques for reasonableness. Several variables, such as aggregating seasoned and unseasoned portfolios, can significantly distort the calculation of required reserves.

43 Determine if ALLL calculations are comprehensive and consider the following factors:

43 A Contingent liabilities - risk associated with undisbursed funds.

43 B Bankrupt and deceased cardholders - such losses are usually not predicted by a simple roll rate analysis.

43 C Economic conditions - unemployment and bankruptcy rates significantly affect asset quality.

43 D Number and volume of workout and re-aged credits.

44 Determine if fraud losses are not charged to the ALLL or included in ALLL calculations per Report of Income instructions. Fraud losses are a non-interest expense.

ASSET SECURITIZATION

Removing designated credit card receivables from the seller's balance sheet to a Special Purpose Vehicle (SPV) while the account ownership is retained by the bank.

FDIC: Refer to the Credit Card Bank Examination Guidance Handbook when examining credit card banks that undertake securitizing credit card receivables.

45 Determine if delinquency and loss rates are similar for both the owned portfolio and the securitized portfolio. (Slightly higher delinquency and net charge off ratios on securitized assets will be prevalent if the bank is experiencing high growth and possesses a significant portion of unseasoned accounts.)

45 A If the delinquency and loss rates deviate significantly, determine if management is selectively prioritizing credit card receivables by either high credit quality or superior past credit

history, setting them aside for asset securitization. The following two ratios are examples where the resulting percentages on a managed and owned basis should approximate one another:

45 A 1. Noncurrent Loans to Gross Loans.
2. Total Past Due Loans to Gross Loans.

46 Consider the on- and off-balance sheet effects of asset securitization. The securitization of credit card receivables generally results in the removal of seasoned accounts.

(Note: Analyzing the performance of securitized assets is important because the level of a credit card bank's earnings and capital are largely dependent upon the quality of its average total assets under management and not merely the owned credit card portfolio.)

THIRD PARTIES

47 Determine whether any credit card related activities are outsourced. If so, complete the third parties review located in the Subprime Lending Loan Reference. Third parties may include brokers, marketing firms, collection or servicing firms, correspondents, affinity partners, and information systems firms.

48 Determine whether the institution shares a BIN (bank identification number) with a third party. Sharing of BINs can create financial liability. As such, an institution sharing a BIN should have a process to identify, monitor and control the risks associated with BIN sharing.

Note: Certain Visa and Mastercard members are assigned BINs (represented by a series of numbers on the credit card) for clearing and settlement of their credit card activities. Members which are licensed specific BINs may allow other members to deposit and receive transactions through those BINs. However, the BIN licensee (holder of the BIN) has primary responsibility for transactions processed through its BIN. In addition, users of a BIN other than the BIN licensee (BIN holder) may share responsibility for transactions processed under that BIN in the event that the licensee fails to meet its membership obligations